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Statement of
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Before the
Subcommittee on General Farm Commodities and Risk Management
Committee on Agriculture
U.S. House of Representatives

The Honorable Jerry Moran
Chairman

Hearing on
The Reauthorization of the Commodity Futures Modernization Act

The Bond Market Association (TBMA) is pleased to present this testimony on issues related to the reauthorization of the Commodities Exchange Act (CEA). Through our offices in New York, Washington and London, the Association represents the $44 trillion global bond markets. Our members include securities firms and banks that underwrite and trade fixed-income securities and related derivative products. The Association also represents the interests of the securitization industry through our Mortgage-Backed Securities and Securitized Products Division and our affiliated organizations, the American Securitization Forum and the European Securitization Forum. Another affiliated organization, the Asset Managers' Forum, represents the interests of institutional bond investors.

TBMA members include all 23 of the primary dealers in U.S. Treasury securities, as recognized by the Federal Reserve Bank of New York, in addition to all major dealers in federal agency bonds as well as mortgage-backed, corporate and municipal securities. Our members are also active in the markets for over-the-counter (OTC) financial contracts involving forward payments or deliveries relating to a variety of fixed-income securities, interest rates and credit products. These include swaps, repurchase agreements (repo) and forward delivery contracts.

TBMA participated actively in the debate that led to the enactment of the Commodity Futures Modernization Act of 2000 (CFMA). At that time, we advocated several changes to the CEA that were viewed as critical to vibrant markets in OTC securities, derivatives and foreign exchange. The CFMA has proved to be extremely successful in that regard, because it clarified the exclusion from the CEA and the jurisdiction of the Commodity Futures Trading Commission (CFTC) of OTC derivatives, swaps, and foreign exchange transactions.[1] The much-needed legal certainty CFMA brought to these important sectors of the capital markets has improved efficiency in the market for U.S. Treasury securities in particular, which allows the government to borrow at a lower cost and save taxpayers money.

We commend Chairman Moran and this subcommittee for reviewing the CFMA in the reauthorization process. In this testimony, the Association would like to share with you our view of markets for fixed-income and related products and the success of the CFMA, which we believe should be left intact. In particular, we would like to highlight the notion that since the enactment of the CFMA, the markets for "cash products" such as bonds and other securities have become even more interrelated with the markets for OTC derivatives such as interest rate and credit default swaps. Maintaining the swap exclusion contained in the CEA has never been more vital.

Cash and Derivatives: Convergence in the Fixed-Income Markets

Over the last decade, and particularly over the last five years, the financial markets have undergone a major transformation in the area of risk management. Products, technologies and strategies have been developed which allow market participants to parse different types of risk and price and manage them separately from each other. This in turn allows users—including, of course, banks and securities firms, but also including corporations in practically every industry—to determine the types and levels of risk they are able to accept, and to find willing counterparties to take on, at reasonable costs, risks they are not able to retain. Whether the risk faced by a firm involves interest rates, exchange rates, defaults on credit, energy prices, metals prices, weather or any of dozens of others, that risk can be managed much more cheaply and efficiently today than ever before. Improvements in risk management at the level of individual firms has led to an overall reduction in systemic risk in the broader economy. Federal Reserve Board Chairman Alan Greenspan made this observation in 2002, telling the Council on Foreign Relations that complex financial instruments developed to manage risk have made the global economy "a far more flexible, efficient and resilient financial system than existed just a quarter-century ago." Chairman Greenspan has reiterated this view on several subsequent occasions.

Perhaps the most important development in this area has been the rapid evolution of the market for OTC derivatives such as swaps, OTC options and forward agreements. Although markets for these products have existed for some time, the depth and liquidity of these markets in recent years have greatly enhanced the efficiency and reduced the cost of managing risk. A major factor contributing to this transformation of risk management is the regulatory structure for OTC derivatives set out in the CEA and clarified and enhanced in the CFMA. The CEA correctly recognizes these

[1] In the case of foreign exchange, the exclusion applies when one of the parties to a contract is a regulated entity. See section 2(c) of the CEA.

products as privately negotiated contracts between sophisticated commercial parties, not as publicly traded securities or futures. Unburdened by the constraints and costs of regulations that appropriately apply to the public securities and futures markets, the markets for OTC derivatives have been able to develop and flourish.

What all OTC derivatives have in common is flexibility. The fact that these contracts are negotiated between two counterparties means they can be tailored to specific needs, unlike a product such as a futures contract, the terms of which are established by the exchanges on which they trade. Although they typically are documented on industry-developed master agreements that help to standardize terms other than the basic economic terms of the contract, virtually all the terms of swap agreements are fully negotiable.

The importance of OTC derivatives is reflected in the growth in their use. Total notional[2] principal amount of interest rate and currency swaps outstanding has grown from around $11 trillion at the end of 1994 to over $161 trillion in the first half of 2004, according to the International Swaps and Derivatives Association (ISDA). In June 2003, there were $5.4 trillion in notional amount of credit default swaps, a product which did not exist at all ten years ago.

The evolution of the OTC derivatives market over the past decade has resulted in its integration with the market for "cash products," or traditional financial instruments such as bonds, loans and similar products. Bonds are debt securities issued by governments, corporations and others. Many OTC derivative products are instruments that represent the right to receive (or the obligation to make) payments calculated with respect to payments on an underlying debt security, loan, interest rate or exchange rate (sometimes referred to as the "reference asset"). OTC derivatives can be used either to hedge the risk from owning a position in the reference asset or to take a position that is the economic equivalent of owning the reference asset. Many counterparties are indifferent to whether they assume exposure to reference assets through the cash or derivatives markets.

The cash and derivatives markets have also converged because the dealers who make markets in these instruments are the same or related entities as those who often hedge their risks from dealing in different products on a global entity basis rather than on a product-by-product basis. The markets for bonds and similar products such as mortgage- and asset-backed securities, collateralized debt obligations (CDOs) and structured notes depend on dealers who act as market-makers[3] and trading counterparties. When an investor wants to buy or sell, say, a U.S. Treasury security, he or she typically trades with a bank or securities firm acting as a dealer. The same is true for OTC derivatives. When a finance or manufacturing company wants to

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[2] Notional value refers to the amount on which a contract is based, not the value at risk. In an interest rate swap for example, the notional amount refers to the amount on which an interest rate payment is calculated.
[3] A "market maker" in the OTC derivatives market is a firm that stands ready to act as a counterparty in OTC transactions.

hedge interest rate risk, for example, the counterparty to the transaction is virtually always a bank or securities firm acting as a dealer. Because dealers serve as counterparties on a wide variety of cash and derivatives transactions, and because certain cash and derivative products tend to behave similarly under similar market conditions, dealers tend to manage their trading in these products on a consolidated basis.

The Commodity Futures Modernization Act

In 1974, when Congress amended the CEA to expand the list of commodities to which it applied, Congress recognized that it was inappropriate to apply the regulatory scheme of the CEA to certain financial products because they were not subject to the same regulatory needs as other products, or because they were adequately regulated by other regulators. For example, Congress excluded transactions in Treasury securities, foreign currency and other enumerated assets from the scope of the CEA. A regulatory exemption regarding swap transactions in the 1980s helped to further protect the burgeoning OTC derivative market, but a decade later it became clear Congress needed to act again to provide the type of legal certainty required for a vibrant OTC derivative market. During the congressional debate on the CFMA, the Association set out our three objectives for the legislation.

- Maintain the OTC markets as a viable alternative to traditional organized exchanges.

- Preserve the enforceability of contracts freely negotiated between market participants.

- Avoid duplicative and unnecessary regulation.

We commend Congress for addressing these concerns and adopting the changes to the CEA discussed below.

Excluded Commodities and Swaps

The CFMA contains a broad exclusion for qualifying transactions in “excluded” commodities. Excluded commodities are clearly defined in new section 2(d) of the CFMA and include interest rates, debt instruments and macroeconomic measures such as an inflation index, among others. The list anticipates those financial measures upon which OTC derivatives are most likely to be based. They are references to measures of risk or other economic variables rather than physical commodities. With section 2(d), the CFMA removed any doubt surrounding the exclusion from the CEA for interest rate and credit derivatives.

The CFMA also includes a broader exclusion from the CEA for swaps than had been previously codified. Swaps between eligible contract participants (a new term defined in the CFMA) that are subject to individual negotiations and are not executed on a trading facility do not fall under the CFTC's jurisdiction. This exclusion is vital to entities using swaps to hedge risk. With this exclusion, Congress recognized that the swaps market is both important to the broader financial markets and effectively regulated. Swap counterparties are typically financial institutions that are already subject to regulation.

Exempt Commodities

The term "exempt" commodity under the CFMA refers to a commodity that is not "excluded" from the CFMA but is also not an agricultural commodity. This is an important distinction that serves to exempt OTC derivatives in energy and metals from most of the provisions of the CEA other than the anti-fraud provisions. In the wake of the Enron bankruptcy, some members of Congress have advocated new regulation for OTC derivatives in energy and metals. The CFTC's swift and successful enforcement action against Enron for manipulation of the natural gas markets has netted $35 million in penalties to date and is a strong argument for leaving the current regulatory approach to OTC derivatives in energy and metals unchanged. The CFMA provided for the CFTC's anti-fraud authority over exempt markets, though some have questioned its applicability to bilateral and multilateral transactions. Clarification was sought in legislation last year and we look forward to working with the CFTC and Congress to resolve this question.

The Definition of Organized Exchange

Another important change under the CFMA was the clarification of the definition of "organized exchange" to essentially mean an entity that facilitates trading by or on behalf of a person that is not an eligible contract participant as defined under the CFMA. This clarification is important because it permits ongoing innovations in clearing systems and trading platforms for OTC derivatives without causing instruments traded on such facilities to become subject to the CEA. Under the revised Treasury amendment, transactions in the enumerated products are excluded from the CEA unless they are traded on an "organized exchange."

Ensure Contract Enforceability

Prior to the CFMA, market participants faced a good deal of legal uncertainty in the area of contract enforcement. Because of the lack of clarity regarding what was exempt from the CEA, counterparties could take the position that a contract was undertaken illegally off an exchange and therefore unenforceable. While such actions were largely without merit, the need to litigate through an uncertain legal environment inhibited the development and innovation of the OTC derivative market in the United States. The clarification on enforceability found in section 22 of the CFMA is an example of another wise policy decision by Congress.

Conclusions

The CFMA strikes a delicate balance between regulating a rapidly changing market and encouraging innovation and diversity. Prior to the CFMA, the OTC derivative market was restrained by legal uncertainty. Thanks to the foresight of Congress and other policymakers, that market is now thriving and helping to save taxpayers money by lowering the cost of borrowing for the federal government. Improved risk management and lower capital costs also help stimulate the broader economy. In the context of the reauthorization process, the Association strongly urges this subcommittee and Congress not to alter any of the fundamental elements of the CFMA that encourage an orderly and innovative OTC derivative market.